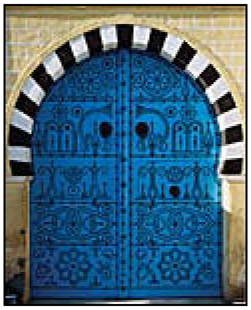

FINANCE and DEVELOPMENT
A quarterly magazine of the IMF

March 2003, Volume 40, Number 1

Managing Oil Wealth

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The political economy of oil-exporting countries—why some of them have done so poorly

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The economic record of mineral-exporting countries has generally been disappointing. Oil exporters, in particular, have done far less well than resource-poor countries over the past few decades, especially when one considers the big revenue gains to the oil-exporting countries since 1973, when oil prices soared. Why is this the case? Perhaps it is because of the way oil economies are run. Managing oil revenues well is much the same as managing any budget well, but some issues are more important for oil exporters. These include how much to save for future generations, how to achieve economic stability in the face of uncertain and widely fluctuating oil revenues and avoid "boom-bust" cycles, and how to ensure that spending is of high quality, whether in the form of large investment projects, public consumption, or subsidies.

The prescriptions for tackling these challenges are straightforward enough in theory. But they often confront the reality of opaque, highly politicized fiscal systems that lack the checks and balances needed to ensure that resources are well employed and to provide the fiscal flexibility needed to adjust spending in line with changes in resources. In extreme cases, when a government remains in power only because of oil money, no fiscal adjustment will be possible unless forced by a crisis. This article compares the political economy of fiscal policy and economic management across oil-exporting countries with widely differing political systems, attempting to identify factors that have helped some to manage their oil revenues effectively and to draw some lessons.

Insights from political science

Just as political traditions shape the use of oil income, the income itself has shaped the political economy of petroleum exporting nations. Revenue streams from "black gold" can finance productive physical and social investment or fuel unsustainable consumption booms and eventual fiscal crises; they can improve public welfare through transparent distributional mechanisms, create elite arenas of competition, or underpin kleptocratic governments. Political science offers insights into the functioning of the state that have implications for economic and fiscal management in oil-exporting countries. Work on the theory of rent-seeking behavior illustrates how rent (see Box 1) reorients economic incentives toward competition for access to oil revenues and away from productive activities, especially in nontransparent environments characterized by political discretion and unclear property rights. These studies and others offer insights that can help build an analytical framework for a better understanding of, and improvements in, fiscal and economic management policies in oil-exporting countries.

Box 1
What is economic rent?

For most of us, rent is what we pay the landlord each month. "Economic rent" means something different. It is the extra amount paid (over what would be paid for the best alternative use) for something whose supply is limited either in nature or because of human ingenuity. For example, a film star might earn a fee many times the salary of a less well known actor. The difference in salary is the economic rent accruing to the star. Similarly, the Organization of the Petroleum Exporting Countries (OPEC) is a cartel that keeps oil supplies artificially low compared with potential world production, raising the price of oil. The additional cost to consumers is economic rent. Seeking economic rents by creating artificial limitations is a booming business and is particularly prevalent in oil economies.

Using tools from political science, oil-exporting countries may be classified as belonging to one of five main groups: mature democracies, factional democracies, paternalistic autocracies, predatory autocracies, or reformist autocracies. These groupings—drawn from a number of academic works on classification of political regimes (see table)—reflect qualitative distinctions in the stability of the political framework and of party systems; the degree of social consensus; the legitimization of authority and the means through which governments (or aspiring governments) obtain and maintain support; and the role of state institutions in underpinning markets and distributing or using oil revenues fairly. These political and institutional features foster differences in the length of political horizons, levels of transparency, policy stability and quality, the political power of the sectors producing tradables other than oil, and the power of interests directly attached to state spending. We examine the characteristics of each category in turn.

Classifying oil exporters[1]

The type of political system affects how oil revenue is spent.

Political features	Institutional implications	Economic implications
Mature democracy		
✍ Stable party system ✍ Range of social consensus ✍ Strong, competent, insulated bureaucracy ✍ Competent, professional judicial system ✍ Highly educated electorate	✍ Long policy horizon ✍ Policy stability, transparency ✍ High competitiveness, low transaction costs ✍ Strong private/traded sector, prostabilization interests vis-à-vis prospending interests	✍ Saving likely ✍ Expenditure smoothing, stabilization ✍ Rents transferred to public through government-provided social services and insurance or direct transfers
Factional democracy		
✍ Government and parties often unstable relative to interest groups ✍ Political support gained through clientelistic ties and provision of patronage ✍ Wide social disparities, lack of consensus ✍ Politicized bureaucracy and judicial system	✍ Short policy horizon ✍ Policy instability, nontransparency, high transaction costs ✍ Strong state role in production ✍ Strong interests attached directly to state expenditures; politically weak private non-oil sector and prostabilization interests	✍ Saving very difficult ✍ Procyclical expenditure; instability ✍ Rents transferred to different interests and to public through subsidies, policy distortions, public employment
Paternalistic autocracy		

• Stable government; legitimacy originally from traditional role, maintained through rent distributionStrong cultural elements of consensus, clientelistic, and nationalistic patterns • Bureaucracy provides both services and public employment	• Long horizon • Policy stability, nontransparency • Low competitiveness, high transaction costs • Strong state role in production • Strong interests attached directly to state expenditures • Weak private sector	• Procyclical expenditure, mixed success with stabilization • Risk of unsustainable long-term spending trajectory leading to political crisis • Little economic diversification
Reformist autocracy		
• Stable government, legitimized by development • Social range of consensus toward development • Constituency in non-oil traded sectors • Insulated technocracy	• Long horizon • Policy stability, nontransparency • Drive for competitiveness, low transaction costs • Strong constituency for stabilization and fiscal restraint	• Expenditure smoothing, stabilization • State investment complementary to competitive private sector • Active exchange rate management to limit Dutch disease
Predatory autocracy		
• Unstable government, legitimized by military force • Lack of consensus-building mechanisms • Bureaucracy exists as mechanism of rent capture and distribution; corrupt judicial system • Little or no civic counterweight	• Short horizon • Policy instability, nontransparency • Low competitiveness, high transaction costs • Spending interests strong vis-à-vis private sector or prostabilization interests	• No saving • Highly procyclical expenditure • Very high government consumption, rent absorption by elites through petty corruption and patronage, capital flight

[1]These classifications are not exhaustive, and some countries have a blend of features from different categories. For example, fiscal federalism is one factor cutting across the categories. The aim is not to create a rigid classification of oil countries but to help provide insights into the policy options available to governments. For use of a similar classification, see, for example, D. Lal, 1995, "Why growth rates differ. The political economy of social capability in 21 developing countries," in *Social Capability and Long-Term Economic Growth*, edited by Bon Ho Koo and Dwight H. Perkins (New York: St. Martin's Press).

Mature democracies. Countries and subnational units classified as mature democracies are characterized by relatively stable party systems, strong electoral institutions, and policies underpinned by a broad social consensus. Political stability and institutional accountability encourage policymakers to think for the long term, as party reputation and economic performance become central to competition for political power. The resulting policy regimes are generally based on transparent information; property rights are clear, and change in government rarely leads to a sweeping realignment of policy priorities. Bureaucracies are competent and relatively insulated; professional judicial systems foster depersonalized functioning of markets and reasonable stability in rules. Political competition over economic performance implies that state investment and the provision of public goods will complement the productivity of the private sector, giving rise to a strong constituency for prudent economic management. These features give citizens the opportunity to provide a critical counterbalance to the influence of interests benefiting from government contracts or spending.

Norway (see Box 2), the American state of Alaska, and the Canadian province of Alberta can be seen as prototype representatives of this category.

Box 2
Norway—Spending the money well

Relative to other oil-exporting countries, Norway has been successful in using its highly consensus-oriented and parliamentary institutions, as well as the involvement of interest groups representing business and labor, to reconcile competing claims for oil revenues with long-term objectives and stabilization goals. This accomplishment is even more remarkable given that Norway has had several changes in government and periods of weak minority government since becoming an oil exporter. However, as a small, trade-dependent nation, Norway also has a strong prostabilization constituency in the form of employees, trade union and business leaders, and voters who are dependent on the non-oil tradables sectors for their well-being and have a good understanding of the need for restraint in public spending and the avoidance of a volatile expenditure pattern. In Norway, in contrast with most other countries, political differences are small and values are egalitarian. The high level of transparency in political and bureaucratic processes reinforces the general trust in the integrity of politicians as well as in the professional skills of the civil service—few Norwegians would question the government's ability to manage Norway's oil rents in an honest and efficient way. Perhaps for this reason, Norway has not moved to distribute oil dividends directly to citizens as was done in more individualistic Alaska.

Reflecting these features, policies are stable in Norway, despite changes in government, and policy formulation has a long-term horizon. However, more recently, the move from deficits to structural budget surpluses and the rapid accumulation of assets in the Government Petroleum Fund have led to mounting political pressures for increased government spending of oil export incomes and made restraint more difficult. Moreover, expenditure commitments will grow in future decades—in particular, as the population ages and pension payments increase—and oil revenues are projected to taper off. These considerations have aroused concern about Norway's ability to sustain its past success in managing its oil wealth.

Factional democracies. Countries classified as factional democracies have several features that distinguish them from mature democracies. Income distribution is unequal and social consensus is elusive. Political parties are often weak and formed around charismatic leaders; electoral institutions are fragile and military intervention in politics is not uncommon. Governments are often unstable; where they are stable, single-party dominance underlies nominally democratic institutions. In both cases, political support derives from systems of patronage. The short-horizon politics of competition for power and state-allocated resources gives rise to unstable policy regimes and nontransparent mechanisms for distributing oil earnings. Economic returns to state expenditures are often low, as politically rational strategies reflect the provision of private goods to narrow interests. Bureaucratic and political elites (including local governments), public sector unions, and the military often succeed in having state spending earmarked directly for their use. Ecuador, Venezuela, and Colombia are representatives of this category of countries.

In Venezuela, oil revenues have shaped politics for decades, creating a state riddled with patronage and entrenched constituencies whose continued loyalty is attached directly to state spending fueled by oil money. Economic performance has been influenced by the volatility of oil revenues and stop-go policies, resulting in boom-bust cycles. Despite Venezuela's estimated $600 billion in oil exports since the 1970s, real per capita income fell by 15 percent between 1973 and 1985, and poverty has increased over the past two decades.

Paternalistic autocracies. Paternalistic autocracies include Saudi Arabia, Kuwait, and some of the smaller states of the Persian Gulf. Governments initially based their legitimacy on traditional and religious authority but, in the process of oil-driven modernization, their legitimacy also becomes attached to the mobilization of oil wealth to prop up living standards. Such governments can be stable for extended periods; they seek consensus and have a much longer policy horizon than many democratic governments. Even though conventional politics provides no immediate countervailing force for fiscal restraint, the concern of these governments with the longer run means that they may also be able to save when revenue is plentiful. However, the evolving role of state spending toward sustaining political support generates rising expenditure commitments—including subsidies; high levels of public employment in low-capacity, overstaffed bureaucracies; and protected, inefficient enterprises—that are hard to cut back and that constrain investment. Such commitments can eventually push these states toward fiscal crisis.

While the development programs implemented by the Gulf states over the past three decades have met with considerable success in many ways, their welfare-oriented strategies have created severe, unintended structural anomalies in the form of persistent dependence on oil for export earnings and fiscal revenues, overgrown public sectors whose omnipresence in the economy stifles the private sector, distorted work incentives, and extreme dependence on governments to provide jobs for Gulf nationals. Over the next decade, the Gulf states will face mounting fiscal pressures to expand public services because of population growth, but, unlike in the past, these countries will not be able to use the public sector to absorb the rapidly increasing number of new entrants to the labor market.

These trends create an urgent need to accelerate non-oil private sector growth to generate new job opportunities for Gulf nationals. However, to realize this objective, Gulf governments will have to abandon development strategies pursued over the past quarter century and overcome severe political hurdles in the way of sustainable strategies.

Predatory autocracies. Predatory autocracies are usually less stable than paternalistic and reformist (see below) autocracies. Power in predatory autocracies is not based on broad public support or economic performance; rather, military power and the support of a narrow elite are the basis for authority. Such regimes tend to act like "roving bandits"; state power faces few constraints; and the exploitation of public and private resources for the gain of the elite is embedded in institutionalized practices. Such regimes often exhibit greater continuity than individual leaders, who face insecurity in their positions and have short time horizons. They are nontransparent and corrupt, and oil wealth delivers little benefit to the population at large. Nigeria under a succession of military rulers is an example.

Oil represents an estimated 37 percent of GDP in Nigeria and 63 percent of consolidated government revenues. Oil revenues are controlled by the public sector and have traditionally greased the functioning of an extensive machinery of rent seeking and political patronage. Oil has also been used, with some success, to hold together a fragile political coalition of diverse ethnic and religious interests. But economic infrastructure remains underdeveloped, and broad provision of public goods is scarce. Unsurprisingly, public expenditure has always spiraled out of control during oil booms, creating considerable macroeconomic instability. Forced and painful adjustment has typically followed. While the elite has flourished, growth has been stagnant, and annual per capita income is estimated to have fallen from about $800 in the early 1980s to about $300 today.

Reformist autocracies. Reformist autocracies lack a broad democratic base of power, instead generating legitimacy through success in attacking poverty through productive investment and economic growth. This objective ensures a long horizon in policymaking; as such, reformist autocracies tend to install autonomous, competent, and politically insulated technocratic elites. The lack of transparency and closed political system inherent in autocratic rule generate rent-seeking pressures but, constrained by their political mandate to make real improvements in the welfare of the poor, such states often deploy oil revenues productively, stimulating economic diversification and growth. Indonesia early in President Suharto's rule is one such case.

Unlike Nigeria, Indonesia often spent its oil revenues well. The technocrats running the economy during the early part of Suharto's rule focused on food security, macroeconomic stabilization, and financial sector reform. Money was spent on improving economic infrastructure, and Indonesia's abundant gas reserves were harnessed to provide a supply of low-cost agricultural inputs to complement the introduction of high-yielding rice varieties. However, the growth of corruption and rent seeking slowly perverted Suharto's regime.

Why did Indonesia (in this period) manage better than Nigeria, both in terms of fiscal and macroeconomic control and in terms of effectiveness of public spending? A large part of the answer lies in their different political economies. Since independence, political power and economic strategies in Nigeria have tended to be defined in regional and ethnic rather than in occupational or class terms. This has led to a continuous search for a constitutional formula to hold together the Nigerian Federation and to an ongoing battle over the regional allocation of public revenues. History shaped Indonesia's politics differently. Suharto focused on stability after the chaos of President Sukarno's "Guided Democracy," when inflation rocketed to 600 percent and food shortages were widespread. Political power was broadly based, with the focus on consensus. Food security and stabilization of the rural population, especially in land-scarce Java, were critical priorities. Even in an autocratic setting, the non-oil tradables sectors—agriculture and, increasingly, labor-intensive industry—constituted a major political interest group with a direct concern for the quality of public spending as well as for avoiding extreme appreciation of the real exchange rate. Unlike Nigeria, Indonesia therefore had the benefit of effective agents of restraint through the first oil windfall.

Drawing conclusions

Mature democracies clearly have some advantages in managing oil revenues for the long term because of their ability to reach consensus, their educated and informed electorates, and a level of transparency that facilitates clear decisions on how to use the money earned over a long horizon. Yet even in these systems (with institutions that were shaped well before oil revenues became large), cautious expenditure management is a continuing struggle. Reformist and traditional autocracies can also sustain long decision horizons and implement developmental policies. But their resistance to transparency and the danger that oil-led spending becomes the major legitimizing force behind the state tend to foster corruption and create difficulties with political transition and problems for governments that get locked into high-spending patterns.

Little good can be expected from predatory autocracies, which sometimes have short horizons and the characteristics of kleptocratic regimes that siphon money from state coffers. Factional democracies present particular challenges, because they lack a sufficiently effective political system to create a consensus among strong competing interests. Special attention will be needed to increase transparency and raise public awareness.

Amid the plethora of competing interests, what is the best way to build support for cautious management? In the end, no single mechanism is likely to provide the ultimate solution: oil-exporting governments will need to use a combination of approaches. They should adopt more cautious, transparent, and flexible budgeting; hedge more; hold larger reserves; and transfer part of the oil earnings to individual citizens during boom periods to reduce pressure for explosive spending followed by lock-in and fiscal crisis during downturns. Some countries are well placed to learn from experience; others, unfortunately, appear to have a long way to go.

A key lesson is that groups favoring longer-term goals can encourage the cautious management of resources. Such groups can include a well-informed civic society ("keep oil revenues out of the hands of the politicians," as in Alaska); parliament (effective consensus building underpinning a transparent budgetary process, as in Norway); those dependent on the non-oil traded sectors (agriculture and fisheries, which lead wage bargaining in Norway; rice in Indonesia; and tin and rubber in Malaysia). These constituencies will benefit from public information and education programs.

Similarly, attempts must be made to get the political debate to span longer horizons. Oil euphoria can be dampened by comparing current revenue to long-run obligations, such as the present value of pension obligations, or to debt service: paying off the debt of Pertamina (the bankrupt state oil company) in 1975 while oil prices were high was a great stabilizer for Indonesia.

External agents of restraint may also have a role in strengthening management. For large-scale industrial projects, private investors can be agents of restraint and risk sharing only if their shares are large enough to make their profits depend on performance of the investment rather than on supplying inputs. Credit ratings for subnational governments offer possible indicators of management effectiveness. If there is a lack of trust between federal and state governments, international agencies could possibly help by offering certified savings facilities for states wishing to retain control of their own surpluses.

Transfers can be a useful mechanism for both distribution of oil earnings and economic stabilization. Only a few countries can implement a transparent Alaska-style system of direct check transfers to individuals, but there may be potential for using oil money to make transparent transfers to communities or schools. There can also be strong arguments for a combination of initially very low non-oil tax rates to ensure compliance and create a culture of paying taxes in the longer term, in parallel with measures focused on improving tax administration to provide greater fiscal flexibility and macroeconomic stabilization.

Whatever approach is taken, it is clear that countries taking a long-term view will benefit the most from their oil resources.

This article is based on a paper presented at the IMF Conference "Fiscal Policy Formulation and Implementation in Oil-Producing Countries," June 5–6, 2002.

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